

THE LEGALITY AND UTILITY OF THE SHAREHOLDER RIGHTS BYLAW

*Jonathan R. Macey**

The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.¹

INTRODUCTION

The vitality of the takeover market is approaching a critical juncture. Certain incumbent management teams and their lawyers and lobbyists have convinced a passel of state legislatures and state judges to try to kill the market for corporate control. With the rise of the poison pill and the "just say no" defense, the outlook has not looked so bleak for takeovers since the collapse of Drexel Burnham in the 1980s killed the junk bond market and with it the ability to finance major league acquisitions. Delaware courts, for example, have validated the poison pill² and seem to be reluctant to restrain its use even in the most egregious

* J. DuPratt White Professor of Law and Director, John M. Olin Program in Law and Economics, Cornell Law School. Andrew Stone, Cornell Law School class of 2000, provided valuable research assistance.

1. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988) (holding that the courts would scrutinize a board attempting to interfere with the shareholder voting process during a contest for corporate control and that, in such situations, the business judgment rule would not apply in full force).

2. See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

circumstances.³ Nevertheless, after a brief respite, takeovers have made a modest comeback in the early 1990s.

Just as lawyers almost killed the takeover market with the invention of the poison pill, lawyers are about to revive it with another legal invention. The invention is the "shareholder rights bylaw" and it promises to be the next major legal battleground in the market for corporate control.⁴

Poison pills of companies with rights bylaws expire automatically whenever there is an all-cash offer for one hundred percent of the company's stock at a price at least twenty-five percent above the market.⁵ Once a bylaw is passed, the only way managers can keep their firm's poison pill in place, once an offer is made, is by getting shareholder approval.⁶ Thus, the shareholder rights bylaw neither inhibits the initial adoption of a poison pill nor prevents the shareholders from approving continuation of a poison pill when they determine that it is the best means for increasing shareholder value. Instead, it merely provides shareholders with a mechanism for policing management, allowing them to ensure that management prerogatives are not placed above the best interests of the shareholders.

The advantage currently enjoyed by incumbent management in the takeover wars is due to legal acceptance of the poison pill. Often, target management uses the pill to thwart outside bids even when target firm shareholders want to sell out. Poison pills chill takeovers by giving target shareholders the right to purchase hundreds of millions of dollars of additional shares at fire sale prices when there is a takeover attempt. These rights make takeovers impossibly expensive. The pills stay in place until target company directors agree to nullify or "rescind" them.⁷

Poison pills were originally intended to slow down takeovers, thereby allowing the board of directors to fully consider a bid, seek other bidders, or negotiate superior terms for the shareholders. In other words, the pill was originally intended to act as a means for allowing the

3. See MARK ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 162 (1994).

4. See generally John C. Coffee, Jr., *The Bylaw Battlefield: Can Institutions Change the Outcome of Corporate Control Contests?*, 51 U. MIAMI L. REV. 605 (1997) (analyzing shareholder power to constrain management from resisting corporate control contests through bylaw amendments). For examples of recent anti-antitakeover actions involving shareholder rights bylaws, see INSTITUTIONAL SHAREHOLDER SERVICES, *THE 1997 PROXY SEASON: THE YEAR IN REVIEW* 25-26, 53-56 (1997).

5. See Coffee, *supra* note 4, at 618.

6. See *id.*

7. See *id.* at 605.

board to fulfill its responsibility of maximizing value for the shareholders. It was not "seen as a means for entrenched management teams to thwart takeovers."⁸

Unfortunately, poison pills have become deal breakers. Courts have become far too reluctant to second-guess directors who refuse to eliminate their firms' pills. These courts are shirking their responsibility to safeguard shareholder value by failing to enforce fiduciary duties and by failing to police director and management conflicts of interest. Target firms can now keep their poison pills in place and "just say no" to would-be acquirers, regardless of the market premiums these acquirers are willing to pay to shareholders. Once management's use of the poison pill is accepted under the power of the business judgment rule, courts have little evaluative say over the way in which it is used or over the decision of whether it will be pulled.⁹

The shareholder rights bylaw eliminates the ability of target company boards of directors to thwart changes of control by keeping their poison pill defensive devices in place once an outside bid has been made. The technique is simple. A shareholder proposes an amendment to the firm's bylaws that requires the company's poison pill (and other defensive measures) to expire automatically whenever the firm receives an all cash offer for one hundred percent of the firm's stock at a price at least twenty-five percent above the market. The only way the firm can keep its poison pill is if the shareholders vote to keep the pill after receiving the offer.

But just as there were considerable initial doubts about the legality of the poison pill, so too are there some who claim that the shareholder rights bylaw is not legal. But these doubts are misplaced. From a legal perspective, the shareholder rights bylaw is less troubling than the poison pills. These bylaws do not encroach on directors' prerogatives to nearly the same extent as poison pills encroach on shareholder rights.

Concerns about the legality of the shareholder rights bylaw center on the applications of state statutory provisions separating ownership and control and giving boards of directors the power to manage or direct the management of a firm. If shareholder rights bylaws infringe too much on boards of directors' power to run companies, they will be declared illegal. But they do not so infringe for three reasons. First, shareholder rights bylaws merely reinforce the corporate manager's respon-

8. Andrew Osterland, *Popping Pills*, FIN. WORLD, Oct. 21, 1996, at 36, 37.

9. See ROE, *supra* note 3, at 166. But see *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-61 (Del. Ch. 1988) (discussing the reasons for not applying the business judgment rule with full force in shareholder voting contexts).

sibility to manage the firm so as to maximize shareholder value. Second, Delaware and most other jurisdictions give shareholders the specific right to amend the bylaws of a corporation. The shareholder rights bylaw is a straightforward exercise of this explicit right granted to shareholders. Third, the adoption of shareholders rights bylaw does not prevent the board of directors from advising shareholders to vote to reject a takeover bid, nor does it prevent shareholders from giving management the authority to use defensive mechanisms such as the poison pill. Instead, finding the shareholder rights bylaw legal merely protects the contractual relationship between investors and management and prevents management from making unilateral decisions contrary to the financial benefit of shareholders. Finally, due to the importance of a vital takeover market to effective corporate governance in the United States, sound policy mandates that courts and legislatures support shareholders in the assertion of their right to pass a shareholder rights bylaw.

Part I discusses the character of the poison pill and the judicial scrutiny of its use. Part I further discusses the ability for the poison pill to be an effective mechanism for increasing shareholder value. Finally, Part I discusses the abuses inherent when a board has the option of a poison pill. Part II discusses some of the systematic concerns implicated by the poison pill and shareholder rights bylaw conflict. First, it evaluates the importance of the market for corporate control as an efficient mechanism for monitoring management and the effects of the poison pill on the vitality of that market. Second, it discusses the evidence showing that jurisdictional competition is a strong force in encouraging lawmakers to establish efficient rules. Thus, a jurisdiction which fails to adapt its legal rules to changing circumstances—such as a jurisdiction that invalidates the shareholder rights bylaw—will likely lose charters. Part III analyzes the effectiveness of the shareholder rights bylaw in diminishing some of the problems posed by the poison pill. And finally, Part IV defends the legality of the rights bylaw under Delaware law. The Article concludes that the shareholder rights bylaw can create efficient outcomes or at least mitigate the inefficiencies of the poison pill; can prevent management from entrenching itself in the face of a tender offer, thereby diminishing the harm poison pills can do to the market for corporate control; is a legal exercise under Delaware law; must be upheld if a jurisdiction is to maintain its position in the market for corporate charters; and finally, leaves most of the positive effects of the poison pill intact.

I. AN ANALYSIS OF THE POISON PILL

A. *Poison Pills and Their Judicial Validation*

Poison pills emerged in the early 1980s as a means for deterring hostile takeovers. Poison pills are often described as shareholder rights plans because they entitle corporate shareholders to buy the corporation's stock at a large discount once the pill is triggered when a third party acquires a certain percentage of the corporation's voting securities.¹⁰ Once a pill is triggered, the dilution of the voting value of a potential acquirer's stock significantly increases the cost to a bidder, usually making a takeover prohibitively expensive unless the pill is redeemed.¹¹

Although poison pills take a variety of forms, they all are designed to create the same effect. Poison pills are instruments that, when triggered, dilute the equity holdings of an unwanted bidder for a target company by permitting the shareholders of the firm to increase their equity holdings at a low cost. The target board creates a new class of preferred stock with limited rights and distributes shares of that stock to the common shareholders.¹² The board retains the option to redeem the pill (the issued stock) for nominal consideration, thereby allowing the board to approve a bid without necessarily prohibitively increasing the cost of a takeover.

The poison pill encourages negotiations between a potential acquirer and a target firm's management in order to maximize value. The pill causes severe economic and voting dilution to the bidder. While poison pills and other defensive measures increase the costs of takeovers, concomitantly decreasing their attractiveness, they can increase wealth when used efficiently.¹³ Principally, the poison pill minimizes the effects of coercion associated with tender offers where the shareholder

10. See Mark J. Loewenstein, *The SEC and the Future of Corporate Governance*, 45 ALA. L. REV. 783, 789-91 (1994).

11. See *id.* at 790.

12. See ROBERT C. CLARK, *CORPORATE LAW* 574-75 (1986).

13. See Loewenstein, *supra* note 10, at 809. Loewenstein presents the following data:

In [1988] there were 198 tender offers in excess of \$1 million each, with a total value of almost \$154 billion. Of these, fifty-nine, or thirty percent were contested. . . . By 1991, the number of tender offers with a value in excess of \$1 million had declined to twenty-three, with a combined value of \$14.2 billion. Of these, only four were contested and of those four only one was completed.

Id.

who does not accept a tender offer finds himself in an inferior position.¹⁴

The court in *Moran v. Household International, Inc.*¹⁵ held that a target's board is authorized pursuant to Delaware law to install a shareholder rights plan or poison pill.¹⁶ Courts originally stated that the use of defensive tactics such as the poison pill would be subject to enhanced scrutiny. For example, *Unocal Corp. v. Mesa Petroleum Co.*¹⁷ set a two-pronged proportionality test as the standard for review of defensive tactics under Delaware law. First, the court stated that defensive measures will be justified only if the target's board can demonstrate that, after reasonable investigation, it determined in good faith that the potential acquirer's offer posed a threat to the firm.¹⁸ Second, the board's response must be proportional to the threat posed by the change in control.¹⁹ If the board satisfies these two prongs, its action will be evaluated under the business judgment rule.²⁰ Later decisions reveal that this supposedly "enhanced" standard of review remains loose and that courts are generally unwilling to police a board's use of the poison pill as an entrenchment device.

In *Paramount Communications, Inc. v. Time Inc.*,²¹ for example, Paramount contended that Time was under an obligation to accept their tender offer which they claimed to be superior to that of Warner, the bidder ultimately successful in merging with Time. The Delaware Supreme Court rejected Paramount's claim, ultimately arguing that the enhanced business judgment rule merely requires that the board's action be within the range of reasonableness.²² Corporate policies or plans that might be interfered with from an offer constitute reasonable justifications for rejecting an offer, even if it clearly means sacrificing a significant economic gain for the shareholders.²³ As Dennis Block and Jonathan Hoff describe the holding:

[T]he court held that Unocal, as an enhancement of the business judgment rule, is not limited to a mechanical comparison of the long-term and short-term value of competing transactions . . . but rather is a

14. See Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113 (1979).

15. 500 A.2d 1346 (Del. 1985).

16. See *id.* at 1353.

17. 493 A.2d 946 (Del. 1985).

18. See *id.* at 955.

19. See *id.*

20. See *id.* at 958.

21. 571 A.2d 1140 (Del. 1989).

22. See *id.* at 1142.

23. See *id.* at 1153.

flexible analytical tool for analyzing whether the board acted in good faith and in an informed manner.²⁴

Later, in *Unitrin, Inc. v. American General Corp.*,²⁵ the Delaware Supreme Court further described the test for analyzing a board's decision to reject a tender offer:

The *ratio decidendi* for the "range of reasonableness" standard is a need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's.²⁶

Unitrin's holding seems to further widen the latitude within which directors can act when faced with a hostile bid. Recently, in *Moore Corp. v. Wallace Computer Services, Inc.*,²⁷ a federal district court interpreting Delaware law also determined that a board's rejection of an unsolicited tender offer without offering any economic alternative ("just say no") is justifiable. Boards are not obligated to obtain short-term economic gains and particularly need not abandon a corporate strategy to obtain such a gain.²⁸

B. Utility of Poison Pills

In a hypothetical world of costless shareholder monitoring (i.e., one in which the interests of shareholders and their manager-agents are perfectly aligned), we begin by asking what the reaction of a firm's majority shareholders would be to the purchase of a substantial minority block of shares. The majority's response critically depends on whether incumbents ("I") believe that the minority purchaser ("M") has assem-

24. Dennis J. Block & Jonathan M. Hoff, 'Just Say No' and the 'Unocal' Test, N.Y. L.J., Oct. 17, 1996, at 5, 6. Randall Thomas described the *Time* decision as one that "may mark the collapse of heightened judicial scrutiny for takeover defensive tactics against hostile tender offers and a retreat to their deferential review under the business judgment rule." Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 517 (1993).

25. 651 A.2d 1361 (Del. 1995).

26. *Id.* at 1388 (quoting *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994)).

27. 907 F. Supp. 1545 (D. Del. 1995).

28. *See id.* at 1560; *see also In re Santa Fe Pac. Corp. Shareholder Litig.*, 669 A.2d 59, 62-63 (Del. 1995) (holding that a board is not under an obligation to seek the highest value reasonably available for shareholders when facing two active bidders).

bled the block for passive investment purposes or as a springboard for a future takeover bid.

The relation between the value of the firm under incumbent ownership-management (" V_I ") and its prospective value under the ownership-management of the current minority shareholder (" V_M ") dictates whether a minority shareholder will find it advantageous to acquire control or simply to remain an investor. If the value of the firm is greater in the hands of the current management ($V_I > V_M$), the substantial minority position will only be for purposes of investment; acquisition of the minority block has nothing to do with a corporate "raid." In fact, many, if not most, acquisitions of substantial minority holdings are made only for investment. By definition, as long as the minority holds for investment only, the majority has no reason to expect it to make a takeover bid.

In some cases, however, the value of the firm will be greater if control is placed in the hands of the current minority ($V_M > V_I$). In these circumstances, the minority stake may be acquired in contemplation of a future tender offer. The acquisition of the minority holding thus provides a signal to the market, transmitting information that the firm's shares are thought to be undervalued in the hands of incumbents relative to their prospective value in the hands of others. Share prices begin to rise in anticipation of a possible takeover.

The appropriate majority response under these circumstances inevitably depends upon whether or not the majority shareholders believe that the minority owner will offer the best price to obtain control and, if a higher offer is predicted, what the cost of eliciting it will be. News that the new minority holder contemplates a takeover alerts other potential bidders that the firm may be undervalued. Incumbent management realizes that these other bidders may decide that they value the firm even more than the current minority and thus would be willing to offer an even higher price. If a higher premium over current market price can be obtained from some third party (" T "), net of the cost of obtaining it, the majority shareholders will of course prefer to thwart the takeover plans of the current minority in order to make way for an auction by other bidders and subsequent acquisition by a third party.²⁹

More formally, even if the firm would be worth more in the hands of the new minority than in the hands of its current owners, its value if owned and managed by a third party (" V_T ") may be even greater: ($V_T >$

29. The fact that shareholders would want an auction after the takeover is threatened does not mean that they would agree to allow auctions *ex ante*, or that auctions are necessarily efficient.

$V_M > V_I$). If so, it is efficient for a third party to obtain control, as this places the firm's resources in the hands of their highest-valued user.³⁰ As explained below, a third party can acquire control in two ways. He can either purchase the firm after the current minority owner completes the contemplated takeover, or he can try to enter the bidding for the firm at the first stage, competing with the minority holder in an auction for control of the firm. Ignoring transaction costs, the highest-valuing party will ultimately control the firm either way. But that does not mean that incumbent shareholders are indifferent to the process. It is in the interest of the incumbents to capture for themselves the largest possible share of any gain from a change in control. With positive transaction costs, this may be accomplished by having as many additional parties as possible bid against M for control. T, as the highest-valuing bidder among them, will be willing to offer the greatest premium, up to $(V_T - V_I)$. The premium of the current minority would be at most only $(V_M - V_I)$. So, in light of positive transactions costs, the incumbents prefer selling directly to T, instead of selling to M, who then sells to T.

It is important to see exactly why incumbent shareholders might not be able to sell their shares directly to the third party, even though T would ultimately offer a greater premium than the current minority shareholder, M. In the modern battle for corporate control of large, publicly held firms, the principal weapon in the arsenal of the tender offeror is the two-tier or two-step bid.³¹ Typically, after a firm has acquired a significant minority block of stock in another firm through open-market purchases, it takes the first step by acquiring a controlling interest in the target firm.³² In the second step, the bidding firm causes a merger between itself (or a wholly owned subsidiary) and the target firm.³³ This merger eliminates the equity interests of the remaining

30. Takeovers themselves have been shown both theoretically and empirically to increase the share prices of target firms. See Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-74 (1981) [hereinafter Easterbrook & Fischel, *Management Role*]; Frank H. Easterbrook & Daniel R. Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733, 1734-45 (1981) [hereinafter Easterbrook & Fischel, *Takeover Bids*].

31. See *Two-Tier Tender Offer Pricing and Non-Tender Offer Purchase Programs—Advance Notice of Possible Commission Action*, Exchange Act Release No. 21,079, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,637 (June 21, 1984) [hereinafter *Two-Tier Pricing*].

32. See William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341, 344.

33. See *id.* The 1982 United States Steel merger with Marathon Oil illustrates the two-step merger. U.S. Steel obtained control of Marathon with a cash tender offer of \$125.00 per share for approximately 51% of Marathon's outstanding common stock. U.S. Steel then acquired the remaining 49% of the stock for \$86.00 in a post-tender-offer merger. See *Radol v. Thomas*, 534 F.

shareholders in the surviving firm. This second step is commonly referred to as a "take-out merger," or more pejoratively, as a "freeze-out merger."³⁴

Single-tier (or "any-or-all") bids, by which bidders agree to purchase all shares tendered at a given price, are used more frequently than explicit two-tier bids or partial offers when the target firm is relatively small.³⁵ But as target firm size increases, two-tier bids replace any-or-all offers as the most common form of tender.³⁶ And, though a bidder may not announce a second (take-out) step initially, seventy-two percent of successful tender offers are followed within five years by a take-out merger.³⁷ A two-tier bid best illustrates the mechanics of the poison pill, not because pills are limited to that context, but simply because of the prevalence of two-tier offers in takeovers of large, publicly held companies.³⁸

The advantage of the two-step takeover (in the eyes of the bidder) is that it places the shareholders of the target firm in a "prisoner's dilemma" that leads them to tender their shares.³⁹ This "prisoner's di-

Supp. 1302, 1305 & n.2 (S.D. Ohio 1982).

34. Thus, a take-out merger is a merger in which a dominant shareholder or shareholder group votes for a merger in which the minority shareholders will not have an equity interest in the surviving firm. See Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 624-25 & n.3 (1981). For overviews with contrasting evaluations of freeze-outs, see Arthur M. Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); Victor Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) [hereinafter Brudney & Chirelstein, *Fair Shares*]; Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter Brudney & Chirelstein, *Corporate Freezeouts*]; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 723-31 (1982); Edward F. Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Simon M. Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955 (1978); Bate C. Toms, III, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548 (1978).

35. See *Two-Tier Pricing*, *supra* note 31, at 86,921.

36. See *id.*

37. See Peter Dodd & Richard Ruback, *Tender Offers and Stockholder Returns*, 5 J. FIN. ECON. 351, 352 n.2 (1977); cf. Carney, *supra* note 32, at 348-49 & n.39 (discussing the prevalence of take-out mergers following tender offers and Dodd & Ruback's empirical evidence).

38. Even without two-tier bids, poison pills are still of value to target shareholders whenever additional time following an initial offer facilitates the development of an auction for their shares. For example, in an all-or-nothing bid, the offeror generally conditions her offer on receiving a certain percentage of the outstanding shares by a certain date. This decreases the likelihood of subsequent bidders trumping the initial offer. Under such circumstances, a poison pill may be a useful device for "buying time" to see if better offers develop.

39. Game theorists use the term "prisoner's dilemma" to describe a situation where the inability of individuals to coordinate their decisions leads to a suboptimal result from the perspective of the decision makers. Brudney and Chirelstein were the first to describe the situation facing target shareholders as a "prisoner's dilemma." See Brudney & Chirelstein, *Fair Shares*, *supra* note

lemma" gives the initial bidder M a tactical advantage over subsequent bidders.⁴⁰ For the tactic to succeed, however, the initial bidder must elicit tenders before a competing bidder can enter the market. A higher blended price offered by a subsequent bidder will defeat the offer of the initial bidder.⁴¹

To illustrate, suppose that the current price of a firm's stock is \$30 per share. The firm has 101 shares outstanding and M has acquired as a "toe hold" one of these shares in an open-market transaction. He purchased the stock after investing \$40 in research indicating that under his ownership/management the value of the firm would increase to \$37 per share. The remaining 100 shares are divided evenly between two people, A and B, neither of whom is able to contact the other one without incurring prohibitive costs.⁴²

34, at 337 (describing "whipsaw" effect of two-tier bids on shareholders). For a description of the "prisoner's dilemma" game, see PETER H. ARANSON, *AMERICAN GOVERNMENT: STRATEGY AND CHOICE* 56-58 (1981), and PAUL A. SAMUELSON, *ECONOMICS* 482-83 (8th ed. 1970).

40. As applied to the tender offer situation, initial bidders have an advantage because the best strategy for each target shareholder is to choose to tender even though a better solution would be for them to agree not to tender. See Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1040 n.59 (1982); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control*, 11 J. FIN. ECON. 5, 31-33 (1983). But see Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 860 (1981) (arguing that shareholders are not placed in a true "prisoner's dilemma" because the gain from the premium offered is greater than the anticipated loss on shares retained). For further discussion of the "prisoner's dilemma" operating in the tender offer situation, see Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1173-74 n.33.

41. This proposition is demonstrated empirically in *Two-Tier Pricing*, *supra* note 31, at 86,941 (Table 9). Prior to the passage of the Williams Act of 1968, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended in scattered sections of 15 U.S.C.), bidders made their purchases on a first-come-first-served basis and limited their offers by requiring target shareholders to tender within a relatively short time. The Williams Act limited these practices. See Carney, *supra* note 32, at 347; see also Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1162-63 (explaining how prior to 1968 offerors could pressure shareholders to tender by sharply limiting the time and conditions of the offer). Under current law, a tender offer must be held open for a minimum of twenty days. See 17 C.F.R. § 240.14e-1(a) (1997). Bidders are required to purchase all shares that are tendered during this period on a pro rata basis. See *id.* § 240.14d-8; Pro Rate Rule, Exchange Act Release No. 19,336, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,306 (Dec. 15, 1982).

42. In the context of actual tender offer situations in publicly held firms, the "prisoner's dilemma" results from the high costs to diverse shareholders of communicating among themselves. The "prisoner's dilemma" is exacerbated in the publicly held firm because individual shareholders who expend resources to communicate information to fellow shareholders bear all of the costs of such communication, but share the benefits collectively with all other shareholders. The efficiency of capital markets makes the dilemma even more acute. Investors who expend resources to uncover information and then attempt to capture the value of their investment by purchasing shares signal the nature of their discovery to other investors; this prevents the initial investor from capturing the full value of her informational investment. See Myron S. Scholes, *The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS.

In this situation, M would make, or threaten to make, a two-tier offer for all of the remaining shares. M would promise to pay a premium for the first fifty shares, but she would also announce that she would follow with a take-out merger for the remaining fifty shares at the pre-tender offer price of \$30. Suppose that the bid is to purchase the first fifty shares for \$40 each and the remaining fifty for \$30 per share, acquiring all shares at an average price of \$35.⁴³ When (and if) the acquisition is completed, the price will climb to \$37 under M's management, giving M a gross return of \$207 (\$200 on the 100 shares purchased from A and B, plus \$7 on the initial share), and profits of \$167 once her research costs are subtracted.

The threatened bid, however, provides useful information to others that the firm may be undervalued.⁴⁴ The news causes other parties to look at the firm, and A and B may be convinced that at least one of the third parties, T, would place a higher value on the firm than does M ($V_T > V_M$), and would be willing eventually to make a better offer, say an average of \$39 per share instead of M's \$35 per share.⁴⁵ But A and B are in a classic "prisoner's dilemma" as illustrated in the matrix below.

179 (1972).

43. The question of how an initial bidder chooses the blended price in a two-tier bid is of considerable interest in itself, but is not addressed here. At a minimum, to create a "prisoner's dilemma," the first-tier bid must be higher than the blended bid expected from a third party. The minority shareholders' "appraisal rights" also set a lower limit for the second-tier bid. See WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 1452-62 (5th ed. 1980) (discussing appraisal rights); see also Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 85 (1969) (contending that the appraisal right is a "remedy of desperation"); Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 229 (1962) (stating that a consequence of the appraisal remedy has been to "consolidate and liberate" management).

44. "The bid itself . . . may reveal much of what the offeror has learned. . . . Indeed, the existence of an offer by itself tells other prospective bidders where to look, even if it conveys no other information." Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1178 & n.45; see also Michael Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 347-48 (1980) (explaining that competing bidders, as well as the target itself, may exploit the information in order to get the best price); Scholes, *supra* note 42, at 183 (arguing that the sale of securities indicates the possession of information on the part of the seller).

45. T's willingness to pay \$39 per share of course implies that the firm is worth more than \$39 to T.

		A's choices	
		Not Tender	Tender
B's choices	Not Tender	\$39 \$39	\$40 \$30
	Tender	\$40 \$30	\$35 \$35

The term “prisoner’s dilemma” describes the situation that arises when two prisoners have been apprehended and accused of committing a crime. Each prisoner will find, when separated from the other, that it is in his individual interest to confess, even though both prisoners would be better off if they could coordinate their activities and forge an enforceable agreement to remain silent. For example, a “prisoner’s dilemma” arises where each prisoner is told that he will receive a jail term of five years if both confess. Each prisoner is also told that if only one of them confesses, the confessing prisoner will receive a lighter sentence of one year, while the uncooperative prisoner will receive a more severe sentence of ten years. Finally, the prisoners are told that if both remain silent, they can only be convicted of a lesser charge, and hence will receive only two years each.

Under these circumstances, the best outcome for each prisoner would be obtained by confessing while the other remains silent. On the other hand, the worst outcome for each prisoner would be to remain silent while the other confesses. Thus, in the absence of an ability to coordinate their actions, the two parties will both confess in order to avoid the worst possible outcome and to have a chance at the best possible outcome. When both confess, they each receive a five-year sentence. Had they been able to coordinate their actions, however, both could have remained silent, each ending in the better position of receiving a two-year sentence.⁴⁶

46. See Carney, *supra* note 32, at 349 n.39.

Shareholders are in a similar position when faced with a takeover bid. Coordination may benefit each shareholder by facilitating collective outcomes that further the aggregate welfare of all shareholders. M often has the advantage of having developed her information first and so will be able to offer and complete acquisition of control before T can make his own bid. If A fails to tender to M, and B does, B receives \$40 for his shares and A receives only \$30. On the other hand, if A and B both tender, B still receives an average of \$35 for his shares. Under these circumstances, B is better off tendering his shares, regardless of whether A tenders or not. By tendering, B earns at least \$5 and perhaps \$10 over the current market price for the shares; by not tendering he loses any premium. A, of course, is in exactly the same position and will act in the same way. The result is that both will tender. Under current law, the offeror, M, will be required to purchase the shares pro rata.⁴⁷ A and B will each receive \$40 for twenty-five of the shares they own and \$30 for the remaining twenty-five shares. If the two could communicate, they would both agree not to tender any of their shares and hold out for the later, higher offer of \$39 per share from T. The inability of A and B to coordinate their activities results in a total loss to them of \$400.⁴⁸

In the real world, of course, there will never be complete certainty that a subsequent bidder will appear. The probability of obtaining control of the firm may not be great enough to induce any additional parties to bid. Assembling the information needed to value the target firm is costly, as is making the bid itself. If the probability of a successful bid is sufficiently low, the expected value of the takeover to other parties may fall short of the costs. If so, a given third party would not choose to enter the bidding contest, although he could be the highest-valuing user of the firm's resources and would have offered the greatest premium to incumbent shareholders.

Shareholders, though, can affect the probabilities so as to increase the size of their premium. Just as M can raise her likelihood of success by shortening the time her offer is open, incumbent shareholders A and B can influence the probabilities the other way. By adopting a poison pill, shareholders can simply win time for T to put together his offer. Thus, each shareholder has a strong interest to agree *ex ante* to certain

47. See *supra* note 41 and accompanying text.

48. If A and B could coordinate their actions, they would receive a total of \$3900 from the sale of their shares (100 shares x \$39 per share). If A and B tender their shares to M, each will receive \$40 for half and \$30 for half. This results in an average price of \$35 and a total of \$3500 ((\$30 x 50 shares) + (\$40 x 50 shares)). The difference of \$400 represents the cost to A and B of being unable to coordinate their strategy.

governance mechanisms that can facilitate the types of coordination that maximize firm value. Empowering managers with the poison pill is one such agreement.

Poison pills act as a powerful resistance tool, allowing management to obtain a higher price for a firm. Defensive tactics to takeovers help avoid the impact of the "prisoner's dilemma" facing shareholders. One of the advantages of the poison pill is that it gives managers the time needed to seek a better offer, either from the initial bidder or from an alternative bidder. Too often, shareholders will be in the classic "prisoner's dilemma," causing them to accept an inferior bid. The poison pill gives managers the ability to avoid the problems of this "prisoner's dilemma" in order to seek a bid that will maximize share value in the takeover market. Shareholders, therefore, can benefit when managers retain the option of invoking a poison pill in order to obtain a higher price for shares.

To return to the numerical example above, suppose again that the target firm's stock trades at \$30 per share. This price reflects the market's expectations about future events, including takeovers.⁴⁹ Assume that before M acquires her share the market perceives a fifty percent chance that the firm will be taken over at an average price of \$35 per share and a fifty percent chance that the firm will not be taken over at all. If the firm is not taken over, it remains in the control of its present management where the market would value it at only \$25 per share. The firm's current worth of \$30 per share is the sum of the expected values of the two events ($\$35 \times .5 + \$25 \times .5 = \$30$).

Shareholders inevitably will search for the best device to mitigate the effect of the "prisoner's dilemma" and buy time for T's subsequent bid. That weapon often may be a poison pill. Like a tender offer, the triggering of a poison pill informs the market that the target firm's stock may be undervalued. Moreover, once a poison pill is triggered, other bidders have more time and thus a greater opportunity to formulate their bids. For both reasons—more information and more time—poison pills

49. In regard to this proposition, Easterbrook and Fischel state:

The value of any stock can be understood as the sum of two components: the price that will prevail in the market if there is no successful offer (multiplied by the likelihood that there will be none) and the price that will be paid in a future tender offer (multiplied by the likelihood that some offer will succeed). A shareholder's welfare is maximized by a legal rule that enables the sum of these two components to reach its highest value.

Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1164. In reality, of course, the value of a stock reflects a whole range of prices and probabilities, but more complex arithmetic would not advance the analysis here.

presumably raise the probability of some bidder T's making an offer and of an auction developing that will increase the price of a successful tender so long as redemption of the pill within a short period of time can reasonably be predicted.

All defensive tactics have the virtue of mitigating the effect of the "prisoner's dilemma" that faces target shareholders and thus of raising the aggregate price that a successful bidder must pay for target shareholders' stock.⁵⁰ Gregg Jarrell has demonstrated the magnitude of shareholders' higher premium gains in an empirical study of target-firm litigation against initial tender offerors.⁵¹ Many defensive tactics pose significant risks to the shareholders of target firms. When faced with these tactics, would-be bidders might find the cost of acquiring the target prohibitive, and may never make a bid in the first place.⁵² This can occur when a firm's management is using the pill as an entrenchment device instead of a tool employed merely to buy time to negotiate for the best deal for shareholders. The higher premiums from resisting tender bids come at some risk that no takeover will subsequently occur. When no takeover ensues, everybody loses.⁵³

The fact that once a tender offer becomes imminent shareholders may want the board to have the option of a poison pill as a defensive tactic to initiate an auction market, does not necessarily mean that the pill is wealth-increasing *ex ante*. Use of defensive tactics against take-

50. "[D]efenders of poison pills note that there is some empirical evidence to support the . . . theory that, at least in the environment of the 1980s, poison pills enabled the shareholders to receive higher premiums than would otherwise have been possible." Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223, 237; see also Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1948-56 (1991) (compiling evidence on shareholder gains under poison pills); Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 520 (1997) [hereinafter Gordon, *An Essay for Warren Buffett*] (describing the increases in average premiums resulting from the use of poison pills).

51. See Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & ECON. 151 (1985). Taking a sample of firms that have resisted initial tender offers by litigating against the bidder, Jarrell finds that the expected gains to target firms from higher subsequent bids outweigh the costs both from the litigation and from the risk that the tender offer will be defeated and no subsequent offer will be made. Defensive tactics, that is, may be "sensible gambles, rather than shameful self-dealing by managers." *Id.* at 175.

52. In addition to the risk that no bid will be forthcoming, there is also the risk that the defense will succeed without a subsequent bid being made. Jarrell found for his sample that litigation against a tender offeror carried a risk of almost twenty-five percent that no takeover would occur after an initial tender offer was defeated by litigation. See *id.* at 174.

53. See Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 N.Y.U. L. REV. 277, 281-91 (1984) (summarizing evidence from a Kidder, Peabody & Co. study on the consequences of defensive tactics).

over bids has provoked considerable controversy. Easterbrook, Fischel, Bebchuk, and Gilson have all argued that managerial resistance to tender offers by tactics that can actually defeat offers (e.g., scorched-earth tactics, poison pills, shark repellents, vexatious litigation) should never be permitted.⁵⁴ Easterbrook and Fischel advocate a rule of complete managerial passivity that would make it illegal for a firm to do anything other than conduct the firm's ordinary business in the face of a tender offer. Their rule would bar even those defensive tactics that do not defeat tender offers but help to create an auction market for the target firm's shares (e.g., mandatory periods before which initial offers must be completed). Bebchuk and Gilson part company from Easterbrook and Fischel on this point.⁵⁵

Easterbrook and Fischel recognize, of course, that resistance may elicit a higher bid, either from the original offeror or from a second bidder, as an auction market for the firm is created. But they see two overriding objections to defensive tactics that lead to auctions and takeovers at higher premiums.⁵⁶ The first is the ability of third parties to free ride on information gathered by the first offeror at some cost. The free ride means that less information is produced, which in turn reduces outside monitoring of managerial performance.⁵⁷ Second, Easterbrook and Fischel object to defensive tactics, even those creating auctions, because the measures consume real resources.⁵⁸

The transfer of resources from lower to higher-valuing users not only raises firms' share prices but also increases total wealth, and so performs an important social function. Prospective tender offerors make considerable contributions to the process of value-creation by locating undervalued assets and providing the information to move them to those who can use them more efficiently. But potential bidders are exposed to victimization by others who can free ride on the information produced and thus reap returns from information obtained without payment.⁵⁹ Even if no defensive tactics are used, subsequent bidders can take ad-

54. See Bebchuk, *supra* note 40, at 1028-29; Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1164; Gilson, *supra* note 40, at 845-46.

55. Compare Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 2-3 (1982), with Bebchuk, *supra* note 40, at 1029-30, and Gilson, *supra* note 40, at 882.

56. See Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1174-82.

57. See *id.* at 1178-80.

58. See *id.* at 1175-76.

59. See *id.* at 1178-80; see also Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980) (analyzing shareholder's ability to free ride on takeover information).

vantage of the information created by the initial bidder because "using information often gives it away."⁶⁰ The initial bid signals to other investors that undervalued assets have been located. Because the subsequent bidders have incurred no costs to acquire information, they can offer more to target-firm shareholders, forcing the initial bidder to increase her offer or lose the opportunity to acquire the target firm.⁶¹

By increasing the premium a first offeror must pay or by reducing the likelihood of his offer succeeding, defensive tactics (including those that encourage creation of auctions) reduce a bidder's incentive to locate attractive targets and invest in first offers. Defensive tactics employed once the initial bid is made afford subsequent bidders an even greater opportunity to free ride on information generated by the first bidder.⁶² It is not just prospective initial bidders who are harmed, how-

60. Easterbrook & Fischel, *supra* note 55, at 4. Easterbrook and Fischel have noted: As a result, no firm wants to be the first bidder unless it has some advantage, such as speed, over subsequent bidders to compensate for the fact that only it had to incur monitoring costs. And, of course, if there is no first bidder there will be no later bidders and no tender premium.

Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1179 (footnote omitted).

61. Bebchuk and Gilson have suggested that initial offerors can prevent a complete free ride on the information they develop by buying a minority stake in the firm, which then appreciates when a subsequent bidder (while free riding on the initial offeror's information) engineers a successful takeover. See Bebchuk, *supra* note 40, at 1035; Gilson, *supra* note 40, at 871. Easterbrook and Fischel quite correctly note, however, that this only mitigates, but by no means dispels, the free rider problem. See Easterbrook & Fischel, *supra* note 55, at 4-5. If the bidder acquires a ten percent stake before making an unsuccessful first bid, she still loses up to ninety percent of the value of her information.

The market for information, however, may make it profitable for some firms to acquire information and trade it when the information becomes a commodity of value. See Easterbrook & Fischel, *supra* note 55, at 18 ("[L]earning about firms and taking them over are separate tasks. . . . Firms specializing in generating information might find their returns highest when they have other firms engage in tender offer auctions.").

One case is illustrative. In *Flynn v. Bass Bros. Enterprises, Inc.*, 744 F.2d 978 (3d Cir. 1984), a firm (Prochemco) had developed information that another corporation (National Alfalfa) was an attractive acquisition. Prochemco's information about National Alfalfa was contained in internal reports, including an appraisal of National Alfalfa's assets. Prochemco originally intended a takeover of National Alfalfa itself, but eventually sold the reports to Bass Brothers for \$130,000. Bass Brothers then used the information to acquire the firm. From the recitation of facts in the Third Circuit's opinion, Bass Brothers apparently had no inkling of the opportunity that National Alfalfa represented until alerted by Prochemco. See *id.* at 981.

Possession of valuable information does not guarantee that a third party will profit from it. A subsequent bidder may free ride on the information and complete a takeover, leaving the developer of the information with no return. The target firm itself will always benefit from the information. The greater certainty of profit increases the incentive of target firms to purchase information, all other things equal.

62. In his study of resistance to tender offers by litigation, Jarrell is unable to account statistically for free riding, but suggests its magnitude may be great enough to make managerial resistance socially undesirable:

ever. Fewer bids also harm shareholders of potential targets.⁶³ As Easterbrook and Fischel observe, the reduced incentive to scrutinize firms for undervaluation affects the entire market for corporate control:

[S]hareholders benefit [from tender offer bids] even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Managers will attempt to reduce agency costs in order to reduce the chance of takeover, and the process of reducing agency costs leads to higher prices for shares.⁶⁴

In general, that is, defensive tactics reduce the number of tender offers launched, and so reduce aggregate firm value. For this reason, the ability to limit the scope of a defensive tactic is in the interest of both shareholders and overall societal wealth.

There is another objection raised by critics to the use of defensive tactics in resisting takeover bids. The very process of resistance itself consumes real resources.⁶⁵ The most obvious example is litigation, which consumes the time and talent of managers, legal staff, judges, and so on. The deadweight social costs can amount to millions of dollars.⁶⁶ These losses are reflected in lower values that bidders will offer when resistance is expected. Shareholder rights bylaws, costless to the firm because their adoption does not require the expenditure of corporate funds, can "economize on costly defensive tactics" and thereby decrease the resource consumption problem of poison pills.⁶⁷

[I]t is important to recognize that this conclusion—that litigious defenses can be beneficial to target shareholders—does not imply that such actions enhance social welfare. Indeed, the opposite is more likely to be true, because litigious defenses redistribute some of the gains from corporate combinations from acquirers to the targets. This redistribution is analogous to a tax on acquirers. Under the assumption that sunk investments by the acquirers produce the bulk of the gains to takeovers, this tax will deter future investments in this valuable acquisition-oriented information.

Jarrell, *supra* note 51, at 175.

63. See Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1180.

64. *Id.* at 1174 (footnote omitted).

65. See *id.* at 1175. The loss is the opportunity cost of the resources used in resistance. If these resources were not consumed in the process of resisting, they would, presumably, be put to some productive use. "Society as a whole loses when traders fight over the gains from trade." Jonathan R. Macey & Fred S. McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 32 n.75 (1985). For demonstrations of this proposition, see Eugene F. Fama & Arthur B. Laffer, *Information and Capital Markets*, 44 J. BUS. 289 (1971); Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971).

66. See Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1175 n.39 (describing the costs of defensive litigation).

67. Coffee, *supra* note 4, at 613.

C. *Abuses of the Poison Pill*

The principal objection to defensive tactics such as the poison pill stems from the Berle-Means paradigm of separation of ownership and control in the modern corporation,⁶⁸ or from what Michael Jensen and William Meckling have analyzed more carefully as the problem of "agency costs" within large firms.⁶⁹ A manager, as the shareholders' agent, should use corporate assets only to increase the value of the firm. In reality, however, with positive shareholder monitoring costs, a manager concerned about his job may be able to act to protect his tenure at shareholders' expense. A substantial newly assembled minority block of shares may be the prelude to a tender offer or some other change in corporate control, putting the manager's future employment at risk. Rather than lose his job, the agency-cost hypothesis predicts that the manager will opportunistically exploit his control of corporate assets to remove the risk.⁷⁰ The agency-cost objection applies to defensive tactics generally. Thus, it is not surprising that poison pills are used to help management entrench itself by "just saying no."

Market correctives inhibit at least some agency-cost problems in the firm. The "market for managers" penalizes management teams who try to advance their own interests at shareholders' expense.⁷¹ Sharehold-

68. ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119-25 (1933).

69. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Jensen and Meckling define and describe the agency relationship as

a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal.

Id. at 308. Because of the tendency of the agent to act in ways that are not in the best interests of the principal, both the principal and the agent have incentives to incur costs to reduce the incidence of such behavior. These costs, along with any residual cost from undesirable behavior that is not deterred, are the costs of a principal-agent relationship. *See id.*

70. See WARREN BUFFET, *KNIGHTS, RAIDERS, AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER* 15-16 (John C. Coffee, Jr. et al. eds., 1988) (stating that managers "simply don't want to be dispossessed—no matter how attractive the offer . . . If they can keep the keys to the store, they usually will."); Charles M. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54, 65 (arguing that poison pills are an effective tool to entrench management).

71. The theory of a "market for managers" goes back at least to Armen A. Alchian, *Corporate Management and Property Rights*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 337, 342-51 (Henry G. Manne ed., 1969). The theory was formalized and extended in Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 292-95 (1980). I do not suggest, of course, that the "market for managers" is perfect in some idealized way, nor that it alone operates to monitor management. I note only that "[a]n important

ers have also demonstrated the ability in other contexts to perceive the agency-cost dilemmas inherent in managerial decisions that affect managers' job tenure, and to mitigate them by charter amendments.⁷² The shareholder rights bylaw is merely the latest manifestation of this mitigation strategy.

The market for corporate control works to identify weak managers. Poison pills can prevent a change in management when extended long enough to keep the costs of a takeover prohibitively high until potential bidders lose interest altogether. Thus, by refusing to redeem a pill, a board can eliminate the firm as a profitable commodity in the takeover market, thereby retaining the status quo in which they maintain control. As a result, not only will the pill possibly prevent shareholders from gaining from a higher price for shares offered by the bidder, inefficient management may not be replaced. This perpetuates the harm that the current management team is imposing both on the shareholders and on societal wealth. Furthermore, the monitoring function served by the market for corporate control is dealt a serious blow because potential acquirers are deterred from tendering an initial offer in the first place because the pill makes the cost of acquisition artificially (and prohibitively) high. Thus, less information is gathered and transmitted in the market about poorly functioning managers and less replacement also results.

The poison pill is open to abuse because it is an effective entrenchment tool, especially when coupled with the low probability of judicial invalidation of the pill.⁷³ Nonetheless, as previously discussed,

premise of corporate finance theory is that markets discipline managers to maximize all stockholders' wealth. Competitive forces in two markets, the market for corporate control and the market for managerial labor services, are widely viewed as providing complementary enforcement of the stockholder wealth maximization rule." Larry Y. Dann & Harry DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control*, 11 J. FIN. ECON. 275, 275 (1983). For empirical evidence on one way the "market for managers" works, see Roger L. Faith et al., *Managerial Rents and Outside Recruitment in the Coasian Firm*, 74 AM. ECON. REV. 660, 662-65 (1984) (stating that firms reduce agency costs by increasing turnover of managers and paying higher salaries as turnover rises).

72. For example, the adoption of "golden parachute" agreements by shareholders as a means of aligning the interests of managers more closely with their own illustrates the ability of shareholders to react effectively to the agency-cost problems described above. See William J. Karney, *Pols Poking Holes in Golden Parachutes*, WALL ST. J., Apr. 16, 1984, at 32. Studies show that adoption of such provisions causes a firm's stock to rise. See Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACCT. & ECON. 179, 183-85 (1985).

73. See Irwin H. Warren & Kevin G. Abrams, *Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests*, 47 BUS. LAW. 647, 647 (1991) (outlining the various legal factors that have strengthened the authority of boards to defend against hostile takeovers).

the poison pill is an important tool for raising shareholder value. Thus, finding ways to keep the pill but curb the abuse should be of critical importance to the development of efficient corporate governance mechanisms.

Finally, even if it is assumed that managers are truly able at times to advance their tenure at the expense of their principals' wealth, it does not follow that shareholders would necessarily want to strip managers of the authority to use poison pills. In the situations identified earlier—where a higher takeover bid can be expected if the takeover is delayed—the incentives of both shareholders and the managers run in the same direction. Admittedly, shareholders and managers might want to use the pill for quite different reasons. But the fact that managers do what shareholders want for selfish reasons is of no concern to shareholders.⁷⁴ Indeed, successful firms are precisely those that align shareholder and manager incentives. Managers may do the right things (from the shareholders' perspective) for the wrong reasons.⁷⁵ The goal is to find ways that either courts or the shareholders can preclude management from doing the wrong things for the wrong reasons.

II. THE SYSTEMATIC EFFECTS OF CORPORATE GOVERNANCE CHOICES

A. *Preserving the Market for Corporate Control*

The market for corporate control is a device for monitoring management. The performance of corporate governance systems can be categorized on the basis of how well they impede managers' ability to divert firm resources to their own, private uses.⁷⁶ Underlying this stan-

74. See generally Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 213 (1950) ("It does not matter through what process of reasoning or motivation such success [i.e., profitability] was achieved. The fact of its accomplishment is sufficient. This is the criterion by which the economic system selects [its] survivors . . .").

75. Jarrell's evidence on litigation defenses to takeover bids is also instructive. Management's decision to litigate in order to block a takeover bid prolongs their job tenure. See Jarrell, *supra* note 51, at 175. However, Jarrell finds even when litigation is successful, most firms are eventually taken over, but at substantial premiums above the initial bid price. Some firms are not taken over, but the gains in auctions and higher premiums produced by litigation exceed the losses to those firms that do not get attractive second bids. *Ex ante*, then, wealth-maximizing shareholders would want management to litigate—as would tenure-maximizing managers themselves. This does not mean, of course, that litigation is economically efficient. It may simply be a way of free-riding on the information developed by the initial bidder whose offer is defeated by litigation.

76. See RAFAEL LA PORTA ET AL., LAW AND FINANCE (National Bureau of Economic Research, Working Paper 5661, 1996); Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 REV. FIN. STUD. 125 (1994).

dard is an understanding that directors should not place their interests ahead of those of the shareholders. When a board uses a defensive mechanism to block a takeover that would be beneficial to the stockholders, they are placing their private interest in retaining control above the shareholders' interests.

An important measure of the performance of a corporate governance system is the functioning of internal and external markets for corporate control. Put simply, if a particular system of corporate governance is functioning properly, inefficient management will be replaced after a contest for control.⁷⁷ As Geoffrey Miller and I have pointed out, "[t]he market for corporate control lies at the heart of the American system of corporate governance."⁷⁸ As early as 1965, Henry Manne posited that the market for corporate control best disciplines managers because, unlike mergers, takeovers do not require the approval of the board of directors of the target firm.⁷⁹ Thus, outside bidders can appeal directly to target shareholders for their approval. And, as Roberta Romano has observed, takeovers provide a backstop mechanism for monitoring corporate performance when other corporate governance devices fail.⁸⁰ Hostile takeovers target poorly performing firms and replace their inadequate or shirking managers with rival management teams thereby keeping the capital market competitive and constraining managers to maximize value for shareholders.⁸¹

The basic theory is simple: outside bidders have an incentive to monitor incumbent managers because they can profit by buying the shares of poorly managed firms and installing better management teams.⁸² Bidders must share these gains with target-firm shareholders, but as long as bidders can earn a risk-adjusted market rate of return on their investments, they will find it in their interests to monitor target management teams on behalf of incumbent firm shareholders. Romano has made an extensive review of the empirical evidence and finds that it

77. See Steven N. Kaplan & Bernadette A. Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers*, 36 J. FIN. ECON. 225, 256-57 (1994).

78. Jonathan R. Macey & Geoffrey P. Miller, *Corporate Governance and Commercial Banking: A Comparative Examination of Germany, Japan, and the United States*, 48 STAN. L. REV. 73, 101 (1995).

79. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 117 (1965).

80. See Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 129-31 (1992).

81. See *id.*

82. See Manne, *supra* note 79, at 113.

is consistent with this inefficient management explanation of takeovers.⁸³

In addition to disciplining particular managers, the market for corporate control has important third-party effects. An active takeover market affects managerial performance in a positive way, even in the absence of a formally announced takeover bid, because target managers will want to keep their share price high in order to reduce the probability that they will be displaced by a hostile takeover. Thus, even if the probability of a takeover is slight, risk-averse managers can be expected to work harder when there is a positive probability that a hostile bid will be announced.

A robust market for corporate control improves management's performance because incumbents inevitably prefer to reduce the probability that an outside bid will be made. Incumbent management will be unsure how much better a particular rival management team is; consequently, management will be unsure how far the firm's share price must fall before attracting a hostile bid. This uncertainty creates an incentive for managers to improve the firm's performance, even if a hostile offer never actually materializes.⁸⁴

Further, those who argue that takeovers are too expensive and therefore too "lumpy" to be an effective governance device ignore the fact that an investor need not launch a full-blown tender offer to put a target company effectively "in play." Investors may launch a proxy contest for as little as \$5000 (down from \$1 million a few years ago).

The market for corporate control serves as a mechanism for replacing weak managers with superior managers and for giving managers greater incentives to perform better. Takeovers provide a form of continued and textured monitoring. In a properly functioning corporate governance system, poorly performing management teams will be replaced.⁸⁵ A corporate governance system that does not replace poorly performing managers is not working very well. The United States's market-oriented system of corporate governance has been hurt in recent years by the wave of anti-takeover statutes and court decisions that are hampering the market for corporate control.⁸⁶ When boards of directors learn to use defense mechanisms to block takeovers, inefficient boards can both avoid being replaced and consequently have less of an incen-

83. See Romano, *supra* note 80, at 130-31.

84. Macey & Miller, *supra* note 78, at 104.

85. See Manne, *supra* note 79, at 113.

86. See *id.*

tive to improve performance to avoid becoming a target. One of the few salutary effects that institutional investors are having on United States corporate governance is their actions directed at lowering or removing some of these barriers, including movements to implement shareholder rights bylaws.

Because the existence of an unfettered poison pill option lowers the probability of a bid ever surfacing, poison pills hinder the effectiveness of the market for corporate control by sending negative cost signals to outside bidders. The greater the likelihood of redemption of the pill, however, the less the existence of the poison pill will deter outside bidders. One way to increase the likelihood of redemption is through the shareholder rights bylaw. The shareholder rights bylaw sends a positive signal to potential bidders that might otherwise be discouraged from seeking to take over a firm knowing that, absent such a bylaw, the invocation of a poison pill would be almost inevitable. Thus, shareholder options that might not otherwise have surfaced will become available.

B. Jurisdictional Competition and the Stakes for Delaware

Like other high-stakes corporate governance games, political considerations will count for at least as much as economic and legal factors in determining the outcomes of disputes over shareholder rights bylaws. State law judges might think that declaring these rights bylaws invalid will be the safest strategy. Jurisdictional competition, however, may make a declaration of validity far more politically safe. The importance of institutional investors has increased in the last decade. They are also more organized, more sophisticated, and more inclined to express their views. Savvy fund managers at behemoths such as the College Retirement Equity Fund (CREF) and the California Public Employees Retirement System (Calpers) will object if managers try to thwart shareholder rights bylaws and may insist that the companies they are investing in incorporate in those jurisdictions that are most attentive to shareholder value.

Delaware, as well as all other jurisdictions, has an incentive to make its corporate governance rules attractive to those who control incorporation decisions—shareholders as the owners of firms. States are self-interested actors, and in the area of takeover rules, Delaware courts and its legislature have adjusted the rules to maintain Delaware's predominant role in the incorporation market of the past.⁸⁷ This reaction is

87. See, e.g., ROE, *supra* note 3, at 163-66.

fueled by the recognition by Delaware officials that its dominance in the market for incorporation cannot be taken for granted.

Jurisdictional competition for corporate charters has been an effective means of maximizing the efficiency of corporate governance in the United States.⁸⁸ And changes in corporate governance rules adverse to the interests of shareholders have empirically proven to spur exit from a less than optimal jurisdictional environment. In fact, Delaware's rise to the winner's circle in the competition for corporate chartering was precipitated by mistakes in New Jersey. Around the turn of the century, the corporation code in New Jersey was tightened, primarily as a result of the political climate.⁸⁹ In addition, judicial hostility to corporations also played a significant role in driving corporate charters out of New Jersey.⁹⁰ The fall of New Jersey in the market for corporate chartering is indicative of the fragility of jurisdictional dominance in this field,⁹¹ especially given the relative ease by which corporations can reincorporate in the modern system.

Delaware risks losing its dominant position in the jurisdictional competition for corporate charters if it does not uphold the legality of a shareholder rights bylaw. Given Delaware's large stake in the corporate chartering market, officials may wish to heed the lessons of the past. This is especially true in light of the importance of this issue to institutional investors who are likely to actively search for jurisdictions friendly to shareholder interests. Delaware has the opportunity to maintain its market share by supporting the shareholder rights bylaw. Failure by Delaware to embrace this legal innovation could be the watershed event that shifts dominance from Delaware to another, more shareholder-friendly jurisdiction. The only question that remains is whether Delaware will accept innovation to maintain its status as a leader or will it, as New Jersey was almost one hundred years ago, be left behind.

88. See generally ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993) (discussing the importance of competition among states for corporate charters in defining American corporate law).

89. See ROBERTA ROMANO, *FOUNDATIONS OF CORPORATE LAW* 97 (1993).

90. See *id.*

91. See generally *id.* (describing New Jersey's demise as the leading state in corporate charters); Henry N. Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEGAL STUD. 129 (1985) (offering a legal and economic account of the decline and fall of the special corporate charter in the United States); Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677 (1989) (documenting the story of New Jersey's innovation, dominance in the market for corporate charters, and loss of position to Delaware).

III. THE UTILITY OF THE SHAREHOLDER RIGHTS BYLAW

Courts claimed that they would police uses of poison pills. Because they fail in this task, however, the shareholder rights bylaw is the only viable alternative for policing the abusive use of poison pills. As one commentator has stated it, "the shareholder effort to use the bylaw amendment process [to gain control over the poison pill] may be provoked by the sense of a judicial failure in enforcing a sufficiently robust set of fiduciary duties for the board."⁹²

The structure of the shareholder rights bylaw is exemplified by the proposal of Guy P. Wyser-Pratte to the shareholders of Pennzoil.⁹³ The proposal resulted after Pennzoil received a tender offer from Union Pacific Resources Group Inc. The Pennzoil board used the poison pill to "just say no" to the offer, maintaining the pill for an extended period of time until the offer eventually terminated.⁹⁴ Wyser-Pratte's proposal applies when there is an offer to purchase one hundred percent of common stock at a twenty-five percent premium over the market price.⁹⁵ It would cause the board of directors to cease using a poison pill to block an offer after ninety days unless the shareholders approve continued use of the pill to block the offer.⁹⁶

Thus, by providing an automatic review by the shareholders of a poison pill, bidders will be more confident that management will be unable to entrench itself in conflict with shareholder interests. Thus, fewer bidders will be deterred from tendering an offer. This benefits the shareholders and overall efficiency in two ways. First, greater monitoring occurs through the market for corporate control. Thus, inefficient managers will be less successful at entrenching themselves and will be replaced, presumably with a management team able to bring a better return to the stockholders and decrease waste and increase productivity in the firm. At the same time, managers will be more likely to perceive the takeover market as a serious threat to their tenure and thereby have a greater incentive to perform well so as to avoid becoming a target. Again, this helps the shareholders and the firm's contribution to societal efficiency. Second, shareholders will have more options to reap the

92. Gordon, *An Essay for Warren Buffett*, *supra* note 50, at 552.

93. See Jonathan R. Macey, *Manager's Journal: A Poison Pill That Shareholders Can Swallow*, WALL ST. J., May 4, 1998, at A22.

94. See *id.*

95. See *id.*

96. See *id.*; see also Seth Goodchild & Daniel J. Buzzetta, *Shareholder Rights By-Law Amendment*, N.Y. L.J., Oct. 30, 1997, at 5 (describing a similar proposal to the shareholders of Wallace Computer Services Inc.).

benefits immediately accompanying a tender offer—a higher value for their shares. Thus, the ninety day time limit allows the shareholders to reap the benefits of the poison pill—by avoiding the “prisoner’s dilemma” and by buying time to negotiate an even better bid—while preventing the board from using the pill as an entrenchment technique. The ability to approve continued use of the pill enables the shareholders to either buy more time or to push away a bidder that they believe is truly adverse to their best interests.

When ownership is widely dispersed, no one shareholder will find it cost effective to draft and obtain adoption of a charter amendment such as the shareholder rights bylaw. Adoption campaigns can be vigorous and expensive and shareholders may have little incentive to pursue the adoption of proposals by the significant free rider problems involved.⁹⁷ Additionally, Easterbrook and Fischel argue that since managers want to keep their jobs, they are unlikely to draft or support charter amendments or changes in bylaws that encourage tender offers.⁹⁸ Nonetheless, shareholder rights bylaws are emerging, largely as the result of efforts by institutional investors less impeded by collective action problems,⁹⁹ including the transaction and information costs associated with obtaining adoption of a bylaw principally favored by shareholders, i.e., a bylaw not likely to align the interests of managers and shareholders.¹⁰⁰

The structure of the corporate governance process prevents shareholders from making rapid changes in their articles of incorporation or from passing bylaws. Substantive changes require a shareholder vote.¹⁰¹ This takes time, particularly when shareholders are widely dispersed. Furthermore, the mechanisms of soliciting proxies are controlled by federal rules,¹⁰² creating further delay. Thus, shareholders’ ability to im-

97. See Loewenstein, *supra* note 10, at 797.

98. See Easterbrook & Fischel, *Management Role*, *supra* note 30, at 1161, 1175, 1181.

99. See Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 347 (1991) (contending that the shareholder “voice” has increased as a result of the rise of institutional investor ownership and the lower collective action barriers facing institutional investors).

100. Easterbrook and Fischel posit that a number of contractual devices in corporate governance emerge if the mechanisms align the interests of managers and shareholders. See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 277-78 (1986).

101. See DEL. CODE ANN. tit. 8, § 242 (b)(1)-(2) (1991); REVISED MODEL BUS. CORP. ACT § 10.03 (1994).

102. The solicitation of proxies is controlled by the Securities and Exchange Act, 15 U.S.C. § 78n (1994), and by Regulation 14A of the Securities and Exchange Commission, 17 C.F.R. § 240.14a (1997). SEC Rule 14a-6 requires that five copies of all proxy statements and accompa-

pede the adoption of a defensive measure such as the poison pill through governance mechanisms cannot easily be accomplished once a bid is in place. The shareholder rights bylaw invests shareholders with the means for monitoring the managerial response to a takeover action prior to such action. Thus, normal delays in amending the charter are avoided in the immediate period after the takeover.

Similarly, the highly deferential business judgment rule makes it difficult for shareholders to challenge a board's action in court. The underlying justification for the business judgment rule is that courts should not substitute their own business judgment for that of the directors, unless the board's actions can be shown to serve no rational business purpose. Thus, a plaintiff challenging a board's decision bears the burden of rebutting the business judgment rule's presumption favoring the board if he is to convince the court to contravene a board's decision.¹⁰³ As discussed earlier, the standard of review of poison pills amounts typically to little more than an application of the business judgment rule. The low probability of shareholder success, combined with the free rider problems associated with successful litigation, normally leaves any one shareholder with little incentive to challenge a board's action in court.

Furthermore, without the shareholder rights bylaw, boards can rely on board composition innovations that make it almost impossible for shareholders to override a board's decision to not redeem a poison pill. As poison pills became more and more effective at thwarting takeovers, acquirers began attempting to overcome the poison pills by coupling a tender offer with a proxy contest to unseat directors and thereby gain the power to redeem the pill.¹⁰⁴ Boards of directors responded with the use of staggered boards, making the unseating of a majority almost impossible in one election alone and thereby stretching the fight for "two elections and often the better part of two years."¹⁰⁵ These tactics have received judicial approval.¹⁰⁶ Similarly, continuing director provisions in poison pills, often characterized as "deadhand" pills, were instituted, granting only continuing directors the right to vote to redeem a pill, thereby making a change in the board ineffective at removing the im-

nying forms be filed with the SEC ten days prior to the date such material is given to stockholders, although the SEC may authorize a reduction in the ten-day period "upon a showing of good cause therefor." § 240.14a-6(a).

103. See *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981).

104. See Gordon, *An Essay for Warren Buffett*, *supra* note 50, at 522-23.

105. Coffee, *supra* note 4, at 606.

106. See Gordon, *An Essay for Warren Buffett*, *supra* note 50, at 523 & n.42.

pediment created by the pill.¹⁰⁷ A recent case applying Georgia law in federal court upheld this type of pill.¹⁰⁸ However, cases in New York and Delaware have invalidated deadhand pills.¹⁰⁹

Overall, shareholders have an incentive to pass a bylaw granting them the means to police poison pills in the absence of an acceptable policing option in the current system. Because the shareholder rights bylaw does not eliminate the poison pill option for a firm, the benefits of the poison pill, including its ability to solve the problems of the classic "prisoner's dilemma" facing shareholders, can still be retained in the face of a takeover. At the same time, poison pills used to block any higher price, as opposed to those used to search for the best price, can be avoided.

In fact, the benefits of poison pills will survive precisely because the self-interest of shareholders will lead them to employ their powers under a shareholder rights bylaw efficiently. First, shareholders recognize that the proper use of the pill can increase the value of their holdings. Second, as described in the analysis of the "prisoner's dilemma", the rational shareholder will prefer the opportunity to agree *ex ante* to mechanisms which eliminate the "coercive" effects of a tender offer. Gordon argues that shareholders can be trusted to make the right choice:

If indeed poison pills provide a mechanism that enhances shareholder welfare—because of the negotiating leverage given the board in facing a potential acquirer—then there is every reason to believe that shareholder action would not drastically detoxify the poison pill. . . . [T]here is no reason to think shareholders would carelessly surrender the pill's advantages. Recent shareholder votes on bylaw amendments regarding poison pills bear this out.¹¹⁰

Rational shareholders may still give managers the discretion to use a poison pill, even recognizing that managerial and shareholder incentives do not always coincide. The interests of shareholders may be served even when managers act perfectly selfishly. If, for example, managers invoke a poison pill solely to keep their jobs in the face of a hostile tender offer but the pill's use causes the value of the company's

107. See *id.* at 531-36.

108. See *Invacare Corp. v. Healthdyne Techs., Inc.*, 968 F. Supp. 1578, 1580-81 (N.D. Ga. 1997).

109. See *Carmody v. Toll Bros., C.A. No. 15983*, 1998 WL 418896, at *1 (Del. Ch. July 27, 1998); *Bank of New York Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482 (Sup. Ct. 1988).

110. Gordon, *An Essay for Warren Buffett*, *supra* note 50, at 550 (citing the results of the Healthdyne/Invacare contest and the case of the May Department Stores as recent examples of economically rational shareholder action in limiting use of poison pills).

shares to rise, rational profit-maximizing shareholders will permit even self-interested managers to use a poison pill. The ultimate test of management action is not motive, but result.

IV. THE LEGALITY OF THE SHAREHOLDER RIGHTS BYLAW IN DELAWARE

Concerns about the legality of the shareholder rights bylaws center around the applications of state statutory provisions such as section 141(a) of Delaware corporate law, which says that a corporation is to be managed by or under the direction of their board of directors.¹¹¹ Also in question is Delaware section 203(a), investing in the board of directors the power and duty to assess and approve business combinations.¹¹² Whether these powers are unduly infringed by allowing shareholders to pass a rights bylaw pursuant to their power to amend the bylaws of a firm under Delaware's section 109(b)¹¹³ is the issue to be resolved.

The legality of the shareholder rights bylaw is an unsettled legal question. It received its only test in a case arising under Oklahoma state law in *International Brotherhood of Teamsters General Fund v. Fleming Cos.*¹¹⁴ In an oral ruling, the judge in *Fleming* upheld the legal validity of a bylaw requiring a shareholder vote on any poison pill before the pill could become effective.¹¹⁵ The Oklahoma statutory provisions in question were almost identical to Delaware sections 141(a) and 109(b).¹¹⁶ The court's ruling was consistent with the core principle that shareholders are the ones most concerned with the marketability of shares and should not be limited in their rights to merely an *ex post* review of a board's actions.¹¹⁷ *Fleming*, therefore, stands as a precedent that shareholders have a legal right to prescribe rules *ex ante* governing

111. See DEL. CODE ANN. tit. 8, § 141(a) (1991).

112. See *id.* § 203(a).

113. See *id.* § 109(b).

114. No. CIV-96-1650-A, 1997 U.S. Dist. LEXIS 2980, at *1 (W.D. Okla. Jan. 24, 1997), stay refused, 1997 U.S. Dist. LEXIS 2979 (W.D. Okla. Feb. 19, 1997). For discussions of the *Fleming* case, see Coffee, *supra* note 4, at 611-13, and Gordon, *An Essay for Warren Buffett*, *supra* note 50, at 544-45.

115. A short form order was also issued, without the court's reasoning. See *International Bhd. of Teamsters Gen. Fund*, 1997 U.S. Dist. LEXIS 2980, at *1; see also Goodchild & Buzzetta, *supra* note 96, at 5, 6 (explaining how the court upheld a shareholder rights bylaw in an oral ruling); *More Fallout from Fleming*, CORP. CONTROL ALERT, May 1997, at 2-4 (explaining the same).

116. See Henry Lesser & Douglas Sugimoto, *Emerging Trends in the Use of Shareholder Bylaw Amendments*, CORP. GOVERNANCE ADVISOR, Sept.-Oct. 1997, at 15, 17.

117. See *International Bhd. of Teamsters Gen. Fund*, 1997 U.S. Dist. LEXIS 2980, at *1.

board discretion in takeover actions.

No Delaware court has addressed the legality of the shareholder rights bylaw. Nevertheless, interpretation of Delaware law and the balancing of the interests of both shareholders and managers counsel against invalidation of such bylaws. As Coffee has described:

Proponents of shareholder authority to adopt a bylaw amendment that requires redemption of a poison pill can advance some non-frivolous arguments for their position: (1) such bylaw amendments do not require expenditure of corporate funds nor typically mandate the taking of any affirmative step (and may in fact economize on costly defensive tactics); (2) they also do not interfere with "ordinary business decisions," as that phrase is usually understood, because a poison pill represents a fundamental financial decision, and one having no impact on "ordinary" day-to-day operations; (3) such bylaw amendments serve to protect shareholder interests in an area where they have a vital interest—namely, the marketability of their shares—because poison pills and shareholder rights plans do necessarily restrict the field of eligible buyers and thus affect share marketability.¹¹⁸

Thus, many of the underlying goals of corporate governance are furthered by the shareholder rights bylaw.

Those court decisions upholding the power of the board to use a poison pill do not circumscribe the shareholder's right to rescind that power. Instead, those cases can be described as establishing a default rule, not an immutable one. It would seem clear that if directors have the legal power to impose a poison pill, *a fortiori*, the shareholders have the authority to impose a modest constraint on that power. Furthermore, cases holding that directors may not delegate management duties are clearly inapplicable to the situation created by the shareholder rights bylaw—where power is taken away by shareholders, not delegated away by the directors themselves. This distinction underscores that directors' powers should be viewed by courts as responsibilities rather than rights. Supporting this precedent, there are three reasons why such a bylaw is not an illegal infringement on the power of the board.

The rules giving directors the power to run firms exist in the first place to ensure accountability by directors and to protect shareholders from secret agreements among other shareholders to change firm strategy. Indeed, historically and at common law, the power to adopt, amend, and repeal bylaws was vested exclusively in the shareholders.¹¹⁹

118. Coffee, *supra* note 4, at 613.

119. See *id.* at 606 n.5.

Section 141(a) of Delaware law provides that “[t]he business and affairs of every corporation organized under this chapter [Delaware General Corporation Law] shall be managed by or under the direction of a board of directors, *except as may be otherwise provided in this chapter or in its certificate of incorporation.*”¹²⁰ Thus, although section 141(a) gives the board the authority to manage the corporation, it makes clear that this authority may be conditioned by other provisions in the corporate law. In other words, section 141(a) contains a cross reference to section 109(b) which specifically gives the shareholders the right to condition the rights or powers of directors through bylaws.¹²¹ Due to its final clause, section 141(a) cannot stand on its own as a defense for those wishing to find the shareholder rights bylaw illegal. Instead, that final clause requires one to examine the remainder of the corporation statute, particularly section 109(b) of the Delaware corporate code.

Section 109 resembles Revised Model Business Corporation Act (“RMBCA”) section 10.20.¹²² RMBCA section 10.20 empowers both the board and the shareholders to amend the bylaws, unless the articles reserve that power exclusively to the shareholders.¹²³ Section 10.20 grants shareholders the power to pass a bylaw and place it beyond board repeal.¹²⁴ Similarly, critical dicta in a Delaware Chancery Court decision indicates that shareholders may reinstate a bylaw repealed by the board and add a provision insulating the reinstated bylaw from amendment by the board.¹²⁵ Nonetheless, shareholders can shield their bylaw from repeal or modification by using procedural limitations—by specifying in the bylaw’s text the requirements for how the board can amend it.¹²⁶

Under section 109(b), shareholders retain the power to adopt, amend, and repeal corporate bylaws.¹²⁷ This specific empowerment of shareholders should trump any vague, general norms about directors’ power to run the firm, particularly because the shareholders rights bylaw does not interfere with directors’ ability to make strategic decisions

120. DEL. CODE ANN. tit. 8, § 141(a) (1991) (emphasis added).

121. *See id.* § 109(b).

122. *See* REVISED MODEL BUS. CORP. ACT § 10.20 (1994).

123. *See id.*

124. *See id.* § 10.20(a)(2).

125. *See* American Int’l Rent A Car, Inc. v. Cross, No. 7583, 1984 WL 8204, at *3 (Del. Ch. May 9, 1984); *see also* John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 890 (1994) (concluding that allowing shareholders to deny the board power to amend a shareholder-approved bylaw reaches the “appropriate reconciliation” for the tension in this area between shareholder rights and board powers).

126. *See* Coffee, *supra* note 4, at 618.

127. *See* DEL. CODE ANN. tit. 8, § 109(b) (1991). For a similar provision in New York, *see* N.Y. BUS. CORP. LAW § 601(a) (McKinney 1986).

about the firm's operation. Delaware section 109(b) states: "[T]he by-laws may contain *any provision*, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers *or the rights or powers of its stockholders, directors, officers or employees.*"¹²⁸ The importance of the shareholder voting process is underscored by this section.¹²⁹

Statutory interpretation rules require that section 141(a)'s exceptions clause includes section 109(b). The language of 109(b) would be meaningless if section 141(a) were construed to give the board of directors exclusive powers over the business and affairs of the corporation, except for matters explicitly made subject to a shareholder vote in other provisions in the statute. It is a well accepted canon of statutory construction that no interpretation should make a provision meaningless.

For that reason, as well as the clear and unequivocal language of section 109(b), shareholders should retain the right to pass a bylaw limiting director authority over takeover bids. Similarly, section 203(a) merely discusses powers, which, according to clear language in section 109(b), can be altered by the shareholders through a bylaw.¹³⁰

Relying on the language of 109(b) to alter the bylaws as definitive also permits shareholders, should they so desire, to empower the board to use poison pills or other defensive mechanisms. As Mark Roe has stated, the empirical evidence suggests that state "antitakeover laws do no more than what charter amendments *could* do."¹³¹ Shareholders have the choice whether to include antitakeover devices in the contractual relationship. In order to find the use of a shareholder rights bylaw legal, the courts need not invalidate the legality of the poison pill. Instead, by embracing the shareholder rights bylaw as legal, courts would merely allow shareholders to choose whether to empower their firm's directors to use antitakeover devices.

Finally, there is a strong argument that a company that adopts a

128. DEL. CODE ANN. tit. 8, § 109(b) (emphasis added).

129. As one Delaware court has stated:

[W]hether the [stockholder] vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.

Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988).

130. See DEL. CODE ANN. tit. 8, § 203(a).

131. See ROE, *supra* note 3, at 161.

shareholder rights bylaw is still managed under the direction of its board anyway. After all, the board still has full power to recommend that shareholders reject an outside bid and firms with rights bylaws still have power to recommend that shareholders vote to retain a poison pill even after a rights bylaw has been enacted.¹³² The shareholder rights bylaw can reasonably be characterized as a corporate governance mechanism as opposed to a means for allowing shareholders to make business decisions. As Coffee describes:

[T]he bylaws are the appropriate location for constraints that limit the exercise of corporate power, including by the directors. The key distinction then seems to be between affirmative instructions to take specific actions (which generally seem impermissible) and negative constraints that affect the allocation of power between the board and the shareholders (which generally seem permissible).¹³³

Alternatively stated, limitations on poison pills, like the shareholder rights bylaw, present “no threat to the board’s agenda control . . . but respects shareholders’ residual governance authority” because the pill “may be categorized as a residual governance mechanism over which the shareholders have reserve authority through a bylaw amendment.”¹³⁴

Even if the governance/agenda line is not completely bright, the shareholder rights bylaw weighs heavier on the governance side. All bylaws interfere to some extent with directors’ unfettered power to run the firm. There must be some space on the legal landscape for shareholder democracy, a concept regularly protected in corporate law.¹³⁵

In fact, the Delaware courts have recognized that legitimate bylaws will sometimes limit director control over management. In *Frantz Manufacturing Co. v. EAC Industries*,¹³⁶ the Delaware Supreme Court upheld a series of bylaws which prohibited a board of directors from issuing stock to an employee stock ownership plan, a measure which could have been used to dilute the power of a stockholder who, absent

132. In *Blasius*, the Delaware Chancery Court recognized this type of distinction when it wrote that “there is a vast difference between expending corporate funds to inform the electorate and exercising power for the primary purpose of foreclosing effective shareholder action.” *Blasius*, 564 A.2d at 663.

133. Coffee, *supra* note 4, at 608.

134. Gordon, *An Essay for Warren Buffett*, *supra* note 50, at 549.

135. For an extensive list of examples of Delaware cases in which the principles of shareholder democracy are protected, see *Blasius*, 564 A.2d at 659 n.2.

136. 501 A.2d 401, 409 (Del. 1985).

the issuance, gains a controlling share of the corporation.¹³⁷ It is difficult to distinguish this bylaw, essentially functioning as an anti-antitakeover device, from bylaws limiting the discretion to use a poison pill. Similarly, the Third Circuit agreed with the Securities and Exchange Commission ("SEC") when it recognized that, under Delaware law, shareholders can legally pass bylaws requiring independent auditors.¹³⁸ This precedent also supports the proposition that bylaws may limit the managerial powers of the board of directors. In other words, the board's managerial power is not absolute and may be affected by actions pursuant to section 109(b).

In *Carmody v. Toll Brothers*,¹³⁹ the Delaware Court of Chancery held that a shareholder rights plan with a "deadhand" feature, providing that it could not be redeemed except by the incumbent directors who adopted the plan or their designated representatives, was subject to challenge for violating various statutory and fiduciary requirements of Delaware law. The provisions in the plaintiff's complaint that deadhand pills are invalid because they violated the provisions of Delaware General Corporation Law section 141(a) are of particular relevance for the present analysis of shareholder rights bylaws. In *Carmody*, the complaining shareholders argued that the deadhand pill impermissibly interfered with the directors' power to manage the business and affairs of the corporation by unlawfully transferring power from the firm's current directors to the directors that enacted the original deadhand pill. However, unlike the situation with a deadhand poison pill, a shareholder rights bylaw is implemented with a shareholder vote. There is a clear and obvious distinction between a shareholders' action that allocates power between shareholders and directors, and the action by a firm's board of directors that deprives future directors of the ability to manage the firm. Also, the Delaware Court of Chancery seemed particularly concerned that not even a vote to replace all of a firm's board of directors could invalidate a deadhand pill without the permission of the continuing directors. By contrast, a shareholder rights bylaw could be enacted that permitted a committee of current directors, or a single director, to keep a firm's defensive devices in place. Finally, unlike the situation with the deadhand poison pill in *Carmody*, the shareholder rights bylaw provides for a prompt shareholder vote to validate the

137. *See id.*

138. *See SEC v. Transamerica Corp.*, 163 F.2d 511, 517 (3d Cir. 1947); *see also Burr v. Burr Corp.*, 291 A.2d 409, 412 (Del. Ch. 1972) (validating shareholder bylaws altering the composition of the board of directors and giving them special powers).

139. C.A. No. 15983, 1998 WL 418896, at *1 (Del. Ch. July 27, 1998).

provisions of the bylaw. The shareholders are free at that time to restore the board's prerogatives to engage in defensive tactics.

The directors' power to manage a firm depends on the definition of the firm. Integral to that definition is the relationship between the shareholders and the board. As one Delaware court has stated, "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."¹⁴⁰ The power given to shareholders to amend the bylaws of a firm recognizes the shareholders' contractual power to define the nature of the firm. Adopting a shareholder rights bylaw is merely an exercise of that definitional power.

CONCLUSION

The shareholder rights bylaw should be upheld in order to protect shareholder interests in takeover actions. Absent such a provision, challenging the use of a poison pill is almost impossible in light of judicial restraint in the face of business judgment matters. Moreover, waging a proxy battle to remove a board using a poison pill is an uncertain and expensive measure, taking up to two years to revoke the poison pill and approve a merger by gaining control of the board.¹⁴¹

The meta-rule at work is that the firm exists to maximize shareholder value. A board of directors has a responsibility to this concept of the firm. As observed earlier, one of the reasons shareholders may find it in their interests to give their agents the authority to use a poison pill is that these devices inhibit two-tier tender offers that place the stockholders in a "prisoner's dilemma." The dilemma prevents stockholders from realizing the full value of their shares in a corporate control transaction. Thus, retaining the option of the poison pill for firms grants boards a powerful tool for ensuring that shareholder value is maximized in contests for corporate control. Adding the shareholder rights bylaw gives the shareholders a means for holding boards accountable in their use of the pill. The combination of the pill and the bylaw maintains the option to obtain benefits from the poison pill while controlling the abuses inherent in the power to use such pills. Firms—and state functionaries such as legislatures and judges—that ignore this point do so at their own peril.

The shareholder rights bylaw already won an important victory when the SEC began requiring that these bylaws, when proposed, must

140. *Blasius*, 564 A.2d at 659.

141. See *Osterland*, *supra* note 8, at 38.

be included in corporate proxy solicitations under SEC rule 14a-8.¹⁴² The SEC has set the stage for a major legal battle. The battle will surface when shareholders approve a proposed shareholder rights bylaw, and the bylaw is then challenged in court by incumbent directors claiming that their “right” to run the company is being usurped. If Delaware judges refuse to respect the rights of these shareholders, it is likely that institutional investors will begin demanding that their firms reincorporate in jurisdictions offering shareholders greater protection.

142. See 17 C.F.R. § 240.14a-8 (1997) (empowering the board to exclude 13 categories of proposals from proxy statements); see also Goodchild & Buzzetta, *supra* note 96, at 6 (explaining how the SEC refused to allow the exclusion of a bylaw proposal where a stockholder relied upon *Fleming*).